Economic uncertainty

weighs demand for commercial property down

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IN THIS EDITION

Commercial property market sentiment in line with business confidence index

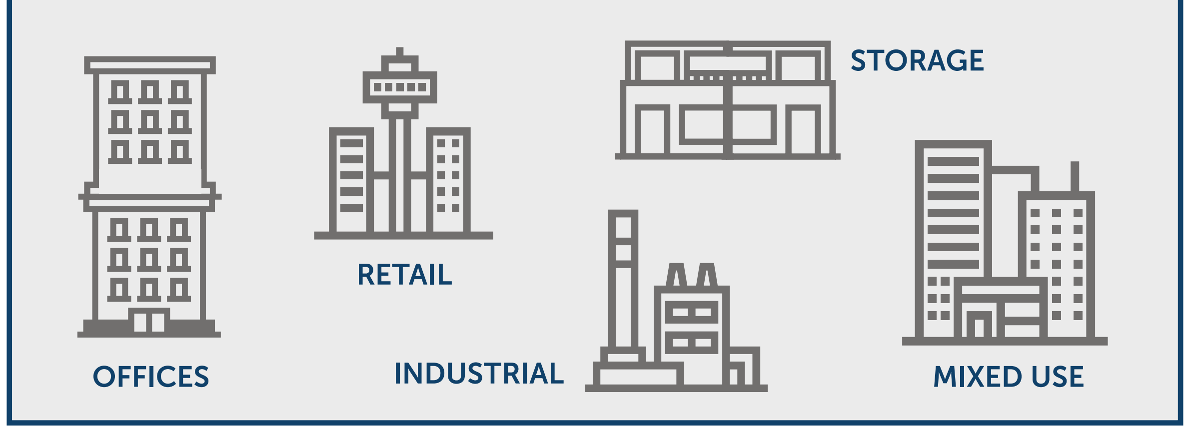
It's no secret that the commercial property market remains under pressure. This is reflected in the fact that the sector is struggling to break through the 70% mark of tenants in good standing and a marginal decrease in the number of commercial tenants in good standing compared to the previous quarter. Tenants in good standing are those that have paid their rental in full and on time at the end of each month.

The RMB/BER Business Confidence Index noted an improvement between Q4 2021 and Q1 2022 from 43 to 46. The small uptick in business confidence – which remained below the neutral 50-mark reached in the second half of 2021 – was supported by the decrease in the number of discouraged job seekers which reduced by 1.4% in Q1 of 2022.

According to Statistics SA, 370 000 new jobs were recorded in the first quarter, reducing the number of the unemployed to 34.5%, while the expanded definition of unemployment decreased by 0.7% to 45.5%. As demand for commercial property struggles to recover, the construction sector echoed this trend by shedding 60 000 jobs in Q1 of 2022.

Bear in mind, however, that the RMB/BER Business Confidence Index Survey for Q1 was conducted in February 2022 before Russia invaded Ukraine and before the oil price surged past $120 per barrel. Not surprisingly business confidence has eroded in Q2 as inflation and rising interest rates place South African consumers under further pressure. The RMB/BER Business Confidence Index reflects this pressure, dropping from 46 to 42 in Q2, reverting back to the low levels seen in the second half of 2021.

TYPES OF COMMERCIAL PROPERTY COVERED BY THIS REPORT



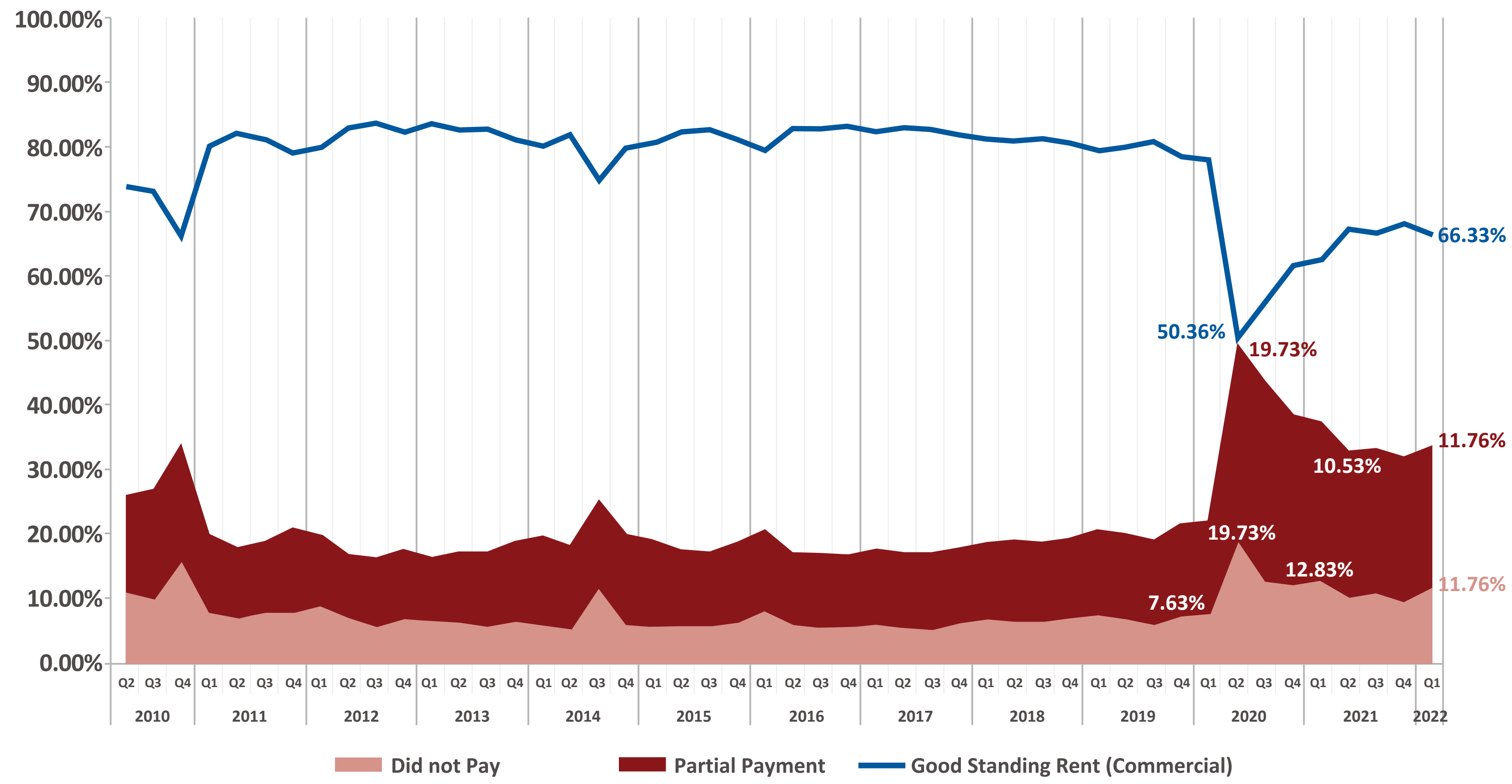
How owners prevented a commercial property apocalypse

Although the residential property sector typically performs slightly better than the commercial property sector, since the onset of the Covid-19 pandemic this gap has grown. Lockdowns forced commercial property owners to choose between vacancies and supporting business owners by means of rental reductions, rental relief and deferments. Billions of rands were committed to relief efforts and will have to be recovered at some point.

These relief initiatives came at a significant cost to property owners who are already subject to high property taxes, rapidly escalating municipal costs and have to contend with poorly maintained public infrastructure. To remain attractive in a highly competitive environment where supply outstrips demand, commercial property owners are forced to allocate their limited funds to provide commercial tenants with uninterrupted utility supplies.

Despite small improvements in Q1, payment behaviour remains subdued

COMMERCIAL TENANTS: PAYMENT BEHAVIOUR



While only 50.3% of commercial tenants were in good standing in Q2 of 2020, tenant payment behaviour saw a steady improvement until it stalled in 2021.

Although Q1 of 2022 indicates a small improvement from Q4 of 2021, more than 10% of commercial tenants did not make any payment towards their rental expenses in Q1 of 2022.

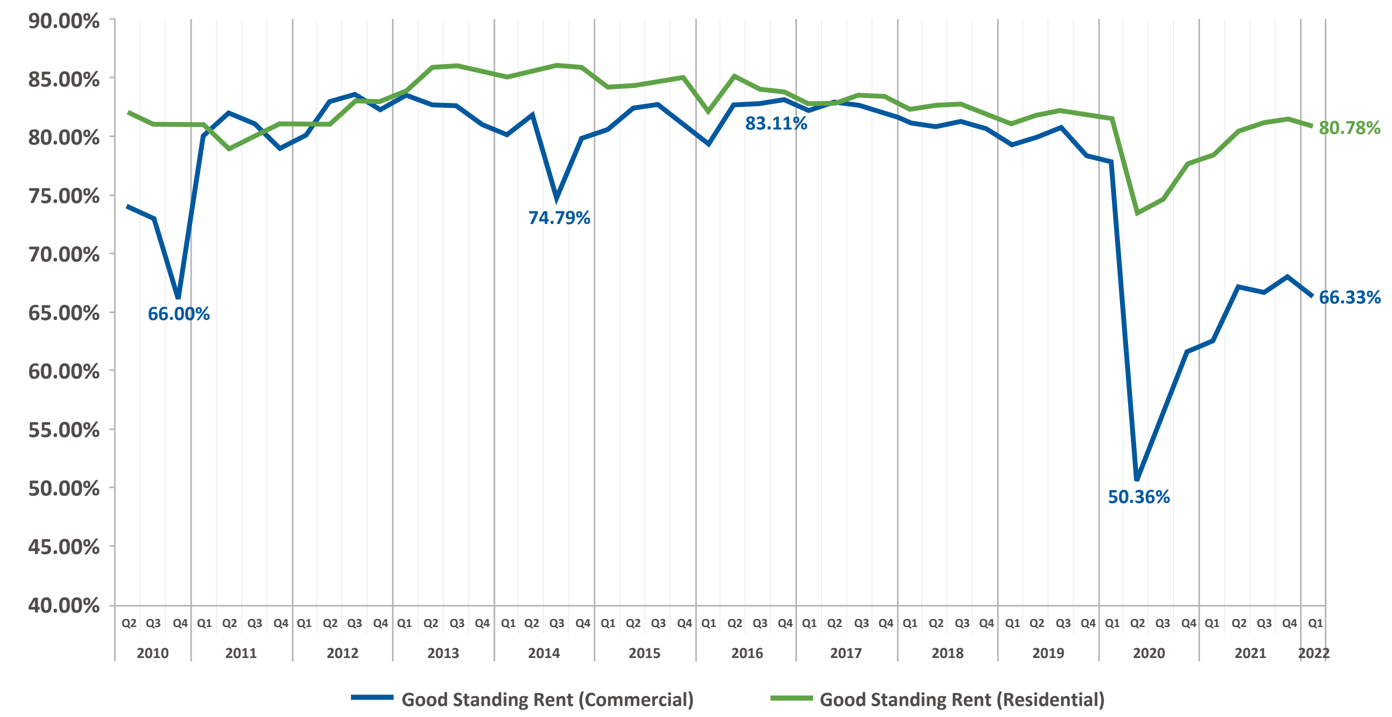
The office and retail market segments appear to be the driving forces holding back the recovery in tenant payment behaviour, although both the industrial and storage categories also saw marginal reductions in the number of tenants in good standing.

Office properties tend to be well located and are often supported by residential properties in close proximity. However, a shortage of centrally located residential properties means that many employees still need to travel in to the office on a daily basis. As more workers start to return to physical offices, one solution to the oversupply of Sub-P and A Grade office space is to convert these properties into affordable residential units to bring office workers closer to economic hubs, particularly given soaring travel costs.

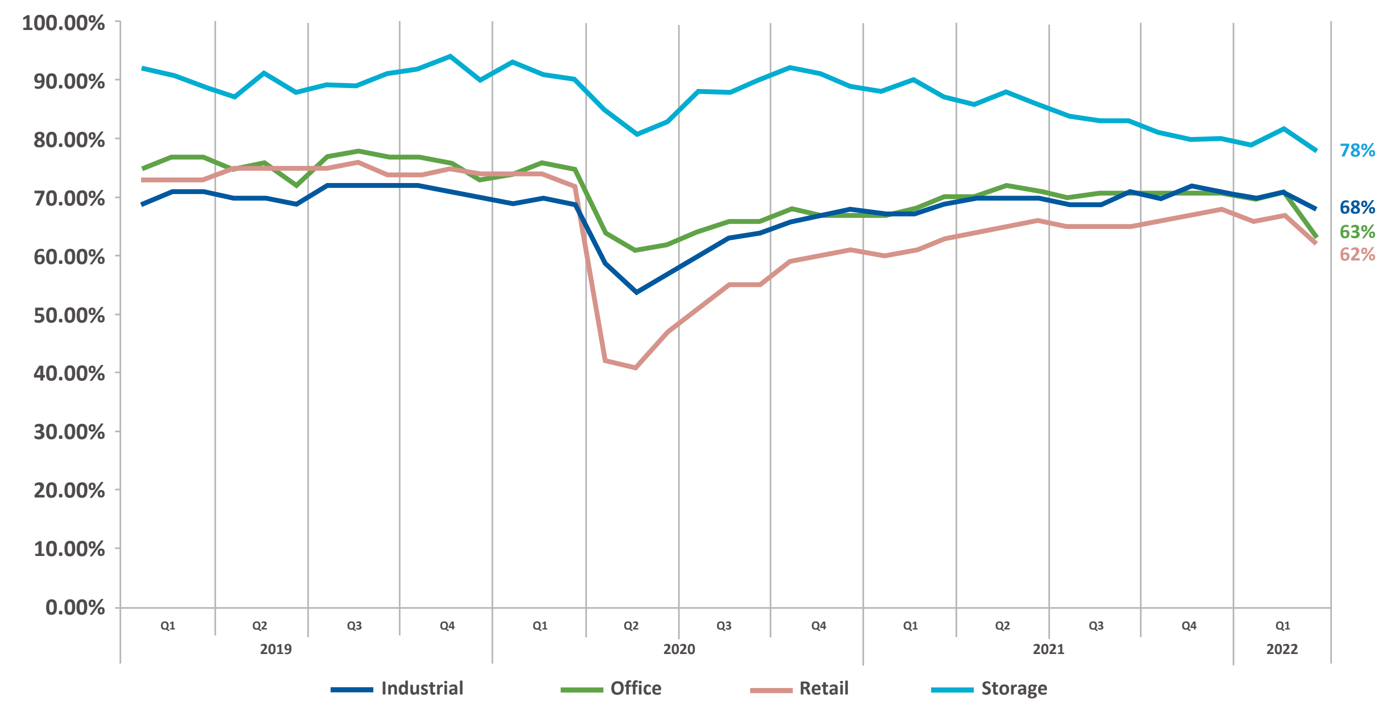
Unfortunately, retail and industrial conversions are not as easily achieved as the physicality and location of these assets is less attractive to residential developers and owners.

National Overview (continued from Page 3)

GOOD STANDING: COMMERCIAL VS RESIDENTIAL RENTALS



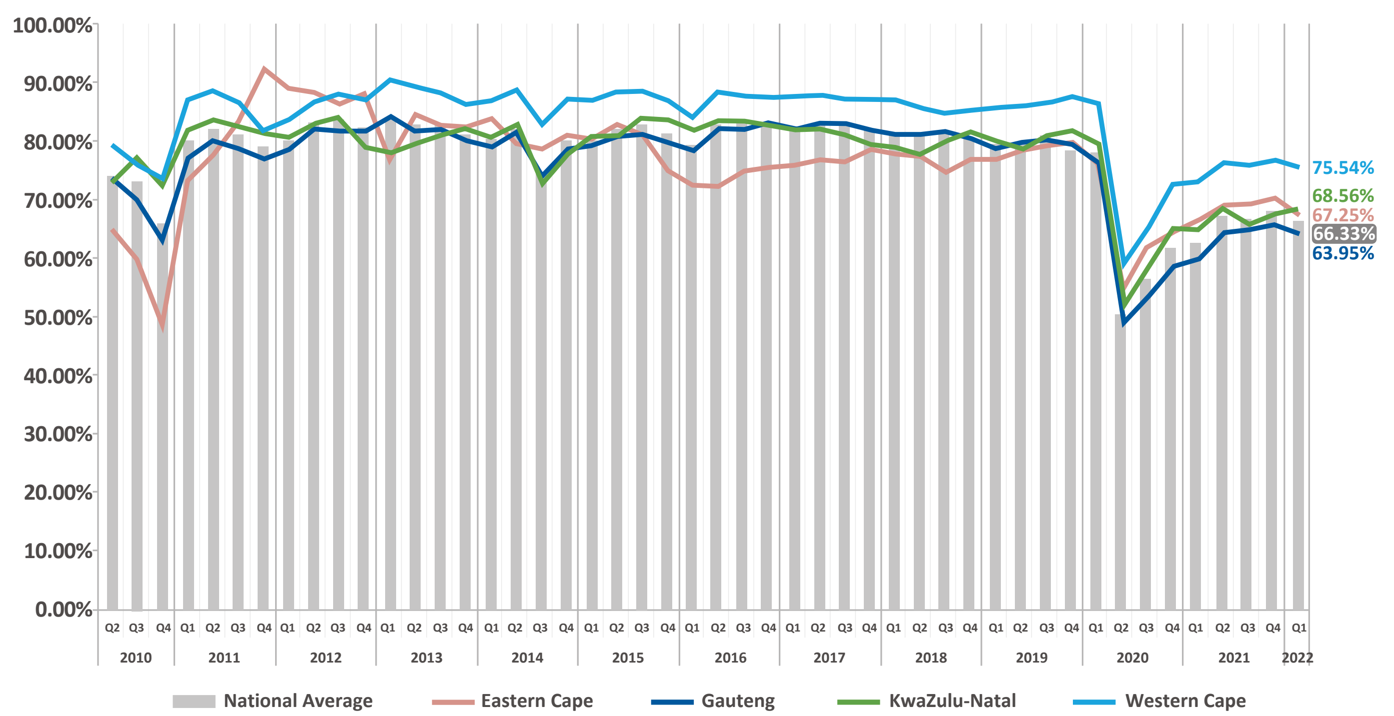
COMMERCIAL RENTAL GOOD STANDING: BY PROPERTY TYPE



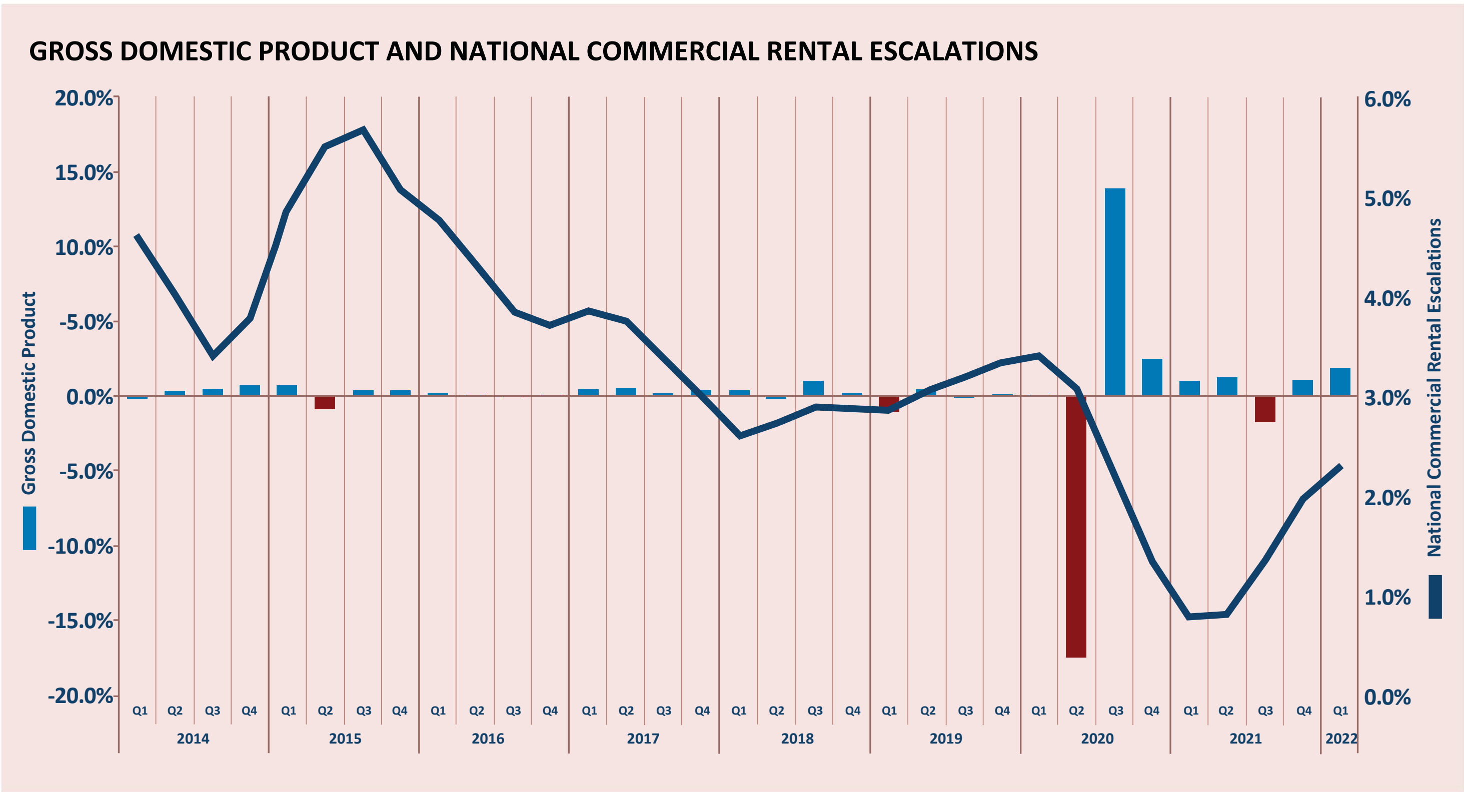
Africa's economic hub, Gauteng, dropped back to 63.95% of tenants in good standing during Q1 of 2022 compared to 65.85% in Q4 of 2021.

The Western Cape maintains its top spot as the best performing province as far as commercial tenants are concerned with 75.54% in good standing. It has held the top spot since 2012. KwaZulu-Natal has recovered from the unrest which took place in Q2 of 2021 and is currently home to the second best performing number of tenants in good standing.

COMMERCIAL RENTALS: GOOD STANDING BY PROVINCE



Why commercial property market forces present a two-fold challenge in the current economic climate



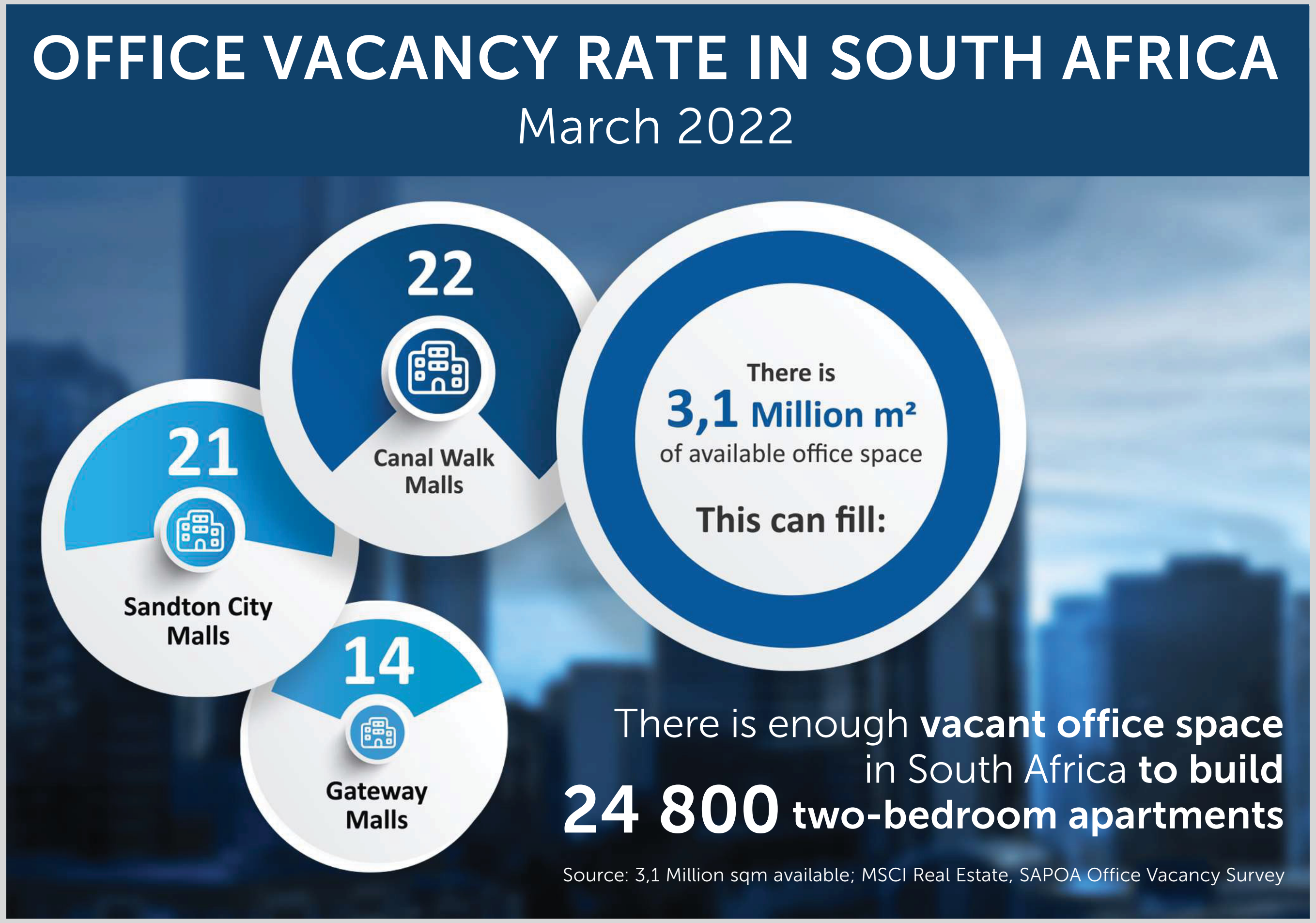
Maintaining Capitalisation (CAP) and Loan to Value (LtV) ratios are preventing traditional free market principles to rectify commercial rental prices. It boils down to a simple equation: if there is an over-supply of a product, then the price will drop to match demand. Demand is then stimulated by lower prices which results in equilibrium.

There is a two-fold challenge in the current economic climate: the first is a lack of real demand due to various local and global economic shocks. Demand will only improve once we have economic growth and businesses start expanding, resulting in the unemployed being absorbed into the economic system. This is not an overnight fix and requires selfless leaders to focus their energy and attention on addressing the constraints to economic growth.

The second challenge is the result of a focus on CAP rate and LtV ratios which sees property owners choosing vacant properties rather than reducing the rand rate per square metre. It might appear short-sighted, but in a highly regulated environment where future access to capital and shareholder perception is heavily determined by asset value, market forces are inhibited from taking their course and seeing a drop in rental prices.

Overall escalations in the first quarter of this year bounced back to 2.3%

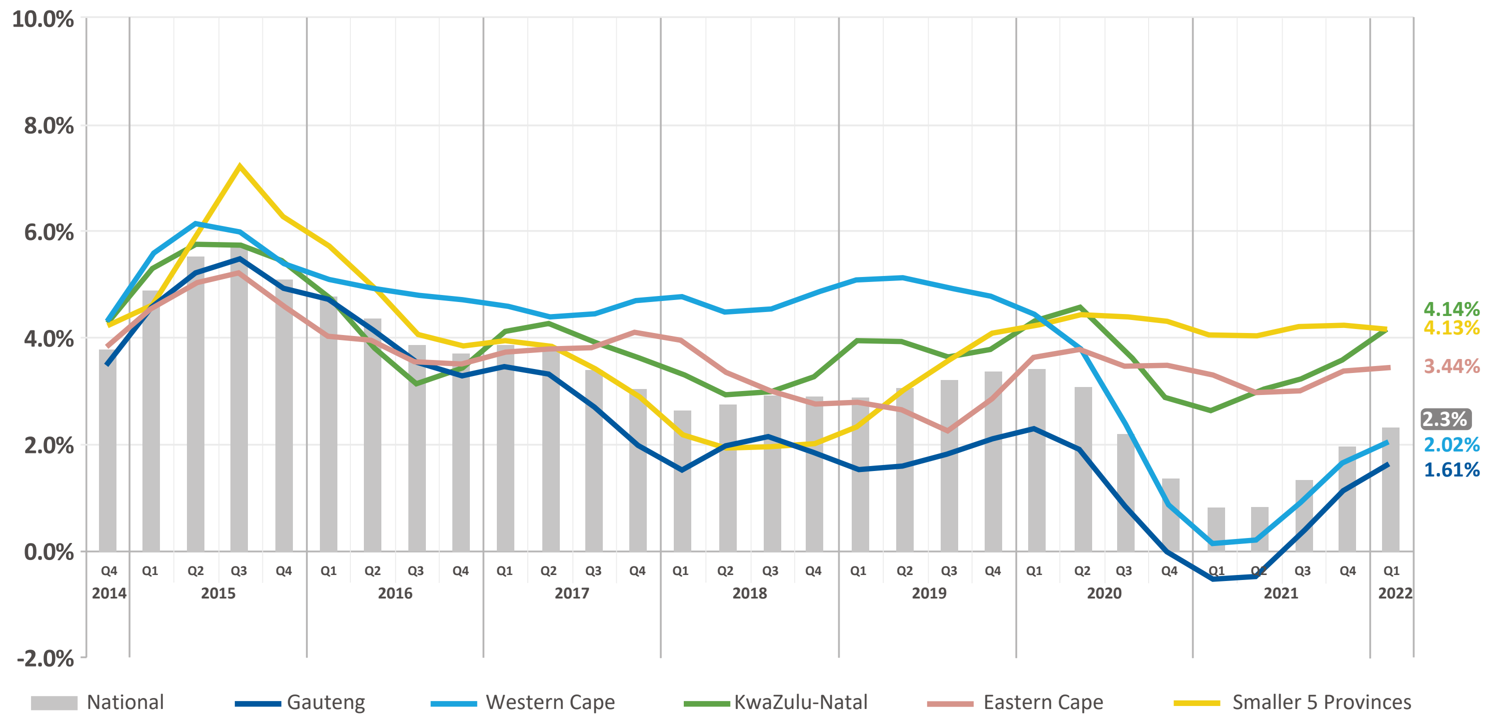
Commercial property rental prices have been decreasing since 2015. Given the high rate of vacancies, de-escalation would have been expected. In 2021, however, commercial properties recorded an average annual escalation, albeit that this was the lowest average escalation on record at 1.23%. In Q1 of 2022, this bounced back to 2.3% although there is still some way to go before escalations achieve the 5.28% noted in 2015. Considering that there was 3.1 million square metres of vacant office space available in March 2022 according to SAPOA's Office Vacancy Survey, the expectation is that rentals would have experienced aggressive de-escalation. However, these remained positive, albeit flat compared to previous years. B and C Grade offices recorded the highest vacancy rate of 19.9% and 16.4% respectively in Q1 of 2022.



Nationally, the average rental escalations for commercial property remained positive.

Gauteng was the only province to experience three consecutive quarters of de-escalation in 2021, and has recorded an average 1.61% escalation for the first quarter of 2022. The Western Cape avoided de-escalations and is currently slightly below the national average escalation rate of 2.3% at 2.02%. The biggest surprise is KwaZulu-Natal's continued recovery with a rental escalation of 4.14%. This trend could be the result of diminished supply given that last year's riots impacted the availability of quality and secure commercial property space.

COMMERCIAL PROPERTY: RENTAL ESCALATION BY PROVINCE



Despite slowing to its lowest value since 2010, the excess supply of commercial property remains daunting

GROSS FIXED CAPITAL FORMATION- NON-RESIDENTIAL BUILDINGS (ACTUAL R' MILLION)

Stats SA: Annual Actual GDP- Gross Fixed Capital Formation, Quarterly.

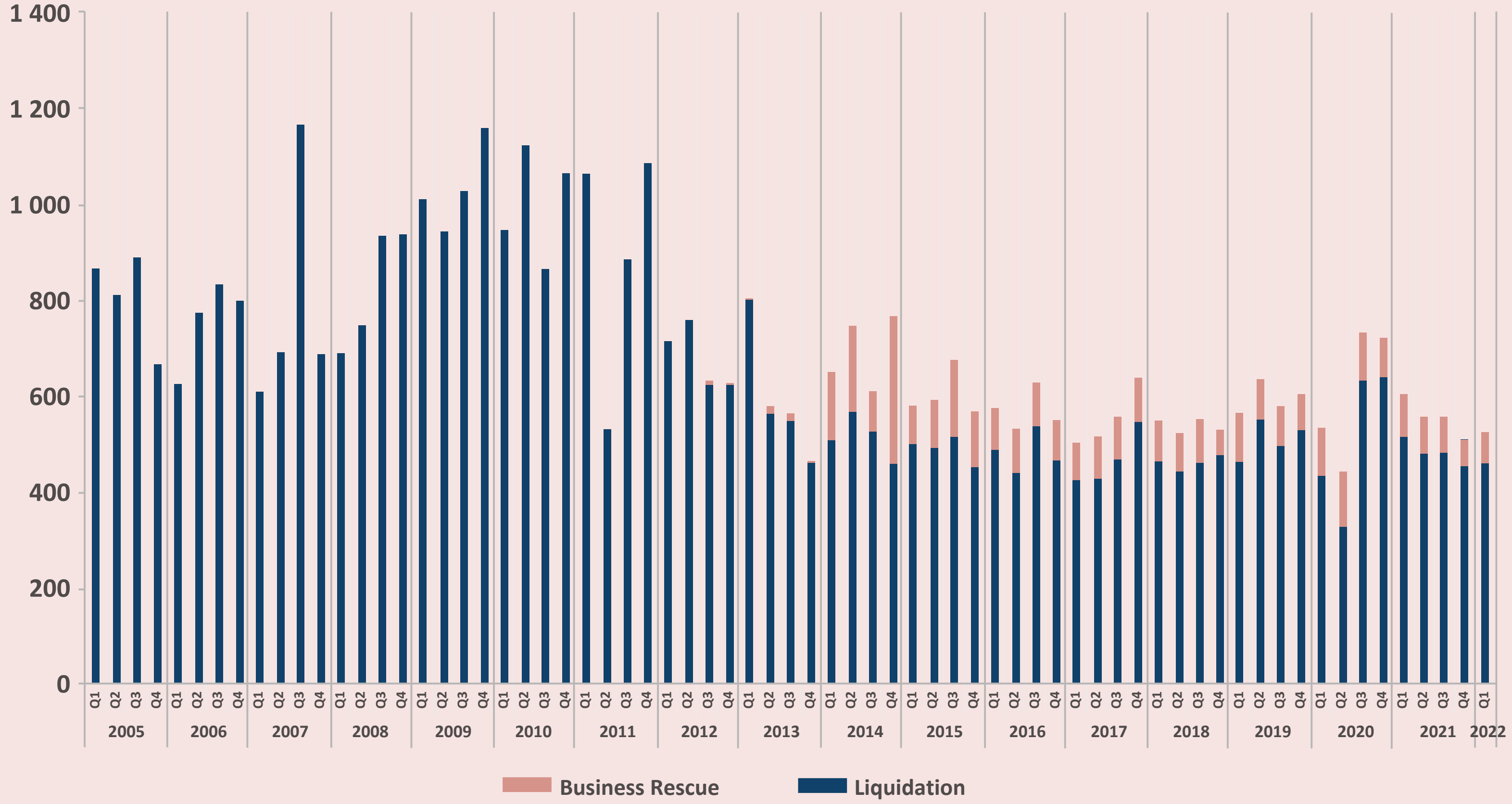
Gross Fixed Capital Formation for non-residential buildings has been on an upward trajectory since the end of 2013.

This increase in non-residential building supply resulted in an excess of commercial property prior to the start of the pandemic. Since then it has slowed to its lowest value since 2010.

Combined with stabilising demand, this might help commercial property owners achieve rental growth and decrease vacancies in the medium to long term. However, this will only be achieved if rental prices are aligned with demand and if tenants are able to increase their turnover in order to meet their rental commitments at the end of each month.

Gross domestic product (GDP) in the first quarter of 2022 recovered to pre-pandemic levels. The focus now needs to be on maintaining this growth rate which will, in turn, drive demand for commercial real estate. The feared commercial real estate apocalypse has not materialised and a growing number of businesses – large and small – are expecting employees to spend at least some of their time in the office. This is being reflected in increased traffic in economic hubs and improved rental escalations. The recovery however, is inconsistent and some areas will need more attention than others.

BUSINESS LIQUIDATIONS AND BUSINESS RESCUE



The rate at which companies are going into liquidation and business rescue has slowed down since the peak in Q3 and Q4 of 2020 when over 1 400 businesses ran aground. Just over 500 businesses liquidated or went into business rescue in Q1 of 2022. The expectation is that this number will continue to slow down in Q2, which will hopefully translate into a recovery in commercial real estate demand. The question, however, is whether this recovery will be fast enough?

CONCLUSION:

Sustainable economic growth is needed to speed up recovery

A number of key business confidence metrics released for Q2 indicate that confidence levels are slipping. This does not auger well for the recovery of the commercial property market which requires sustainable economic growth. Until that is achieved, we expect the commercial property market's recovery to be muted at best. With a continued focus on Capitalisation and Loan to Value ratios inhibiting a drop in commercial rental prices, we are not likely to see an increase in demand soon. While this lack of demand continues as global and national shocks emerge one after the other, we will only see a measurable improvement when business expansion is made possible through real growth in the economy.